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Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
U.S. Department of the Interior
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Dear Mr. Guzy:

RE: SHELL COMMENTS ON VALUATION OF CRUDE OIL PRODUCED ON FEDERAL LEASES
63 FR 38343 (JULY 16, 1998)

These comments are submitted on behalf of Shell Oil Company and its affiliates, Shell Offshore Inc., Shell Deepwater Development Inc., Shell Deepwater Production Inc., and Shell Western E&P Inc., on the MMS request for further comments on oil valuation published on July 16, 1998. Shell has participated by commenting on each of the MMS oil valuation proposals. However, the limited short comment period on this proposal has restricted Shell's ability to produce in depth comments.

Although Shell was encouraged that the MMS has withdrawn the proposed new definition of affiliate and has officially adopted its previous 1988 definition, this small change does not substantially address the flawed MMS approach to valuation reflected in the other definitions noted in Shell's comments and in the substantive proposals of the valuation regulation themselves. For example, MMS in its "gross proceeds" definition continues to assert a right to receive royalty on the gross proceeds not of its lessee as provided in the 1988 regulations but on all gross proceeds accruing for disposition of the oil. This clearly implies that other proceeds received by non-lessees away from the lease may be subject to royalty. It is on this flawed concept of a right to collect royalty on proceeds away from the lease that the MMS proposal fleshes out the details of the substantive valuation proposals.

MMS assurances of non-enforcement of breach of duty to market are insufficient to allay lessee concerns. First, federal lessees do not believe that the duty to put production in marketable condition encompasses a duty to market the production at no cost to the federal lessor. Absent specific statutory or lease language this fee to market concept flies in the face of a long line of private and state cases which hold that such costs are to be shared by lessor and lessee. A pronouncement of validity by MMS based on arm's-length dispositions in the open market away from a lease by parties other than the lessee is precisely the kind of concern that lessees have expressed. The definition of gross proceeds as all consideration accruing for disposition of a lease product other than by the lessee clearly insinuates an intent on the part of MMS to make this kind of assessment.

The real issues of concern in valuation are whether value determination will be made at the lease, and when value is determined away from the lease, whether adequate deductions back to the lease will be given. MMS has expressed in their proposal a clear intent to unfairly minimize deductions away from the lease. In addition, nowhere in the proposed regulation does MMS state that index minus limited MMS deductions will equal gross proceeds. As a result, this leaves the clear implication that royalties paid on index may later be subject to assessment for under payment under a gross proceeds concept. At least the 1988 definition of gross proceeds was limited to proceeds received by the lessee itself and was indicative of a market for oil and gas at the lease itself.

MMS has offered to restrict tracing to the single exchanges and will require index pricing for all multiple exchanges even when arm's-length exchanges are involved. Since royalties based on index are never equated to gross proceeds, this leaves open a continual second guess by MMS. In the gas negotiated rulemaking, MMS understood the need to clarify that payment under index was equivalent to gross proceeds. The adoption of index for multiple exchange did not also address the principal problem of acceptance and recognition of the appropriate deductions to achieve value back to the lease. MMS has corrected one problem related to tracing, but has at the same time created a new difficulty with a required index that does not allow adequate allowance to bring index value back to the lease.

Other major sources of confusion through use of definitions appears in the definition of gathering and transportation. Gathering is defined as both on lease and off lease movement to a central accumulation point or treatment point. Transportation appears as a subset of gathering by its definition of movement off lease to a point of sale or delivery. Since gathering costs are specifically excluded from transportation allowance costs, "transportation" off lease is not permitted an allowance since they are disqualified as gathering costs. This confusion arises since gathering pivots on the concept of movement and centralization or aggregation of production and physical characteristic of production while "transportation" is defined by movement only. In most instances of "transportation" away from a lease there is also a movement to sale or delivery to shore which enhances the value of the production. In most instances gathering off lease really means gathering to an immediately adjacent lease. For offshore production these MMS definitions continue to describe a development and production scenario which is based on a historical concept of OCS development (shallow water, mature infrastructure) which fails to recognize the advances of technology in subsea production.

This MMS royalty regulatory vision of offshore is based on a limited view of multiple wells on lease or production from multiple leases on a unit gathered to a central facility platform where the production is cleaned up and placed in a pipeline to move to shore and market. In this offshore production scenario the central facilities platform may serve production from several leases in a unit or several wells located on a single lease. Even in these cases, off lease and off unit gathering is frequently associated with a central facility platform which is located either on or immediately adjacent to the lease or unit. MMS readily and regularly accepts transportation allowance for movement off lease away from the central facilities platform located on the surface.

In subsea development, multiple wells are drilled and produced subsea on a lease or on several leases participating in a unit. The production from these subsea wells is gathered to a production manifold located on the sea floor. This manifold functions essentially as a central gathering platform similar to a central facility platform. However, actual treatment of the production cannot take place because it is not currently technologically or economically feasible. From the subsea manifold the production is then transported great distances through a subsea pipeline to a distant platform. Under similar circumstances, a surface structure would be granted transportation allowance. Transportation from the subsea manifold should be accorded the same treatment. At this surface platform production is treated and then placed in another pipeline for ultimate transportation to shore.

Every issue of transportation for royalty allowance purposes requires a two step analysis. First, what activity is encompassed by transportation? Second, what is the value of the transportation allowance?

MMS's interpretation on what falls into the category of transportation has over the years been a fluid. Among the relevant factors MMS has considered are movement off the lease/unit, physical characteristic of production (pipeline quality), movement before or after the royalty settlement point, location of sales point, purpose of the movement (e.g. to move toward first sale). Over the years in determining transportation various weights have been assigned to these individual factors. For example, on the West Coast the tendency has been to favor onshore production treatment. MMS has in these cases approved transportation to shore of raw bulk production. In the Gulf of Mexico, MMS has also recognized transportation of bulk raw production from multiple leases to a central onshore treatment facility as transportation for allowance purposes.

When subsea systems are utilized as the primary development system for lease/unit development, the treatment of subsea production to achieve pipeline quality is impossible at the lease/unit. Subsea systems, by their very nature, do not allow separation and delivery of production on the lease because of the absence of surface facilities. Royalty settlement takes place at the surface platform located remotely from the lease/unit because it is more technically practical and economically feasible. In many instances, lease development would not have been economic utilizing a platform type development. The one common thread running through almost every MMS transportation allowance characterization is movement off and away from the lease or unit. This is the fact which resounds so forcefully in subsea development, namely, production is physically moved at great cost long distances nearer to shore where it is more easily sold and is in fact more valuable. For example, Shell's Mensa production moves 60+ miles to West Delta 143 platform. The selection of subsea systems for lease/unit development is principally driven by economics and technology. In most instances, lease/unit development would not have been economic utilizing a platform type development. If a surface platform type development had been used to develop Mensa, movement of production away from the lease to West Delta 143 would clearly have been deemed transportation and a royalty allowance for this service would have been provided. Simply the fact that a different development system was utilized should therefore not preclude production movement away from the lease/unit from being deemed transportation and a suitable royalty allowance provided in this and other subsea development situations.

In every subsea transportation case, a service is being performed. In most cases, production is moved great distances off the lease or unit. Therefore, it is necessary to determine how large the allowance should be. In resolving the transportation allowance issue, MMS should not become mired in regulatory confusion by placing itself in the uncomfortable position of pronouncing on FERC jurisdiction issues in order to determine the amount of transportation allowance. In so doing, the agency has missed the most relevant fact of offshore development, namely, that a transportation movement service has been provided for which value must be paid. Jurisdictional statutes such as the Natural Gas Act and the former regulator of oil, the Interstate Commerce Act, have specific statutory mandates and criteria which are intended to further the purposes of assuring fair and equal access and prevention of discriminatory rates. They are not intended, and have never purported to be determinative, in distinguishing transportation and gathering for royalty transportation purposes. All parties should realize and recognize this. Although MMS has used FERC to validate value of transportation, this use of FERC jurisdiction is unnecessary. The value of the transportation service to the non-affiliated party is the best measure of transportation value and consequently of the size of the allowance. MMS has for oil valuation repeatedly extolled the reliability of comparison to arm's-length transactions. Yet MMS has repeatedly refused to recognize the comparability of arm's-length transportation as valid and valuable for transportation allowance determination. Use of arm's-length transportation, i.e. the value paid by non-affiliated parties to move through a pipeline, makes FERC jurisdictional determinations unnecessary. This is especially true when the purpose of the FERC jurisdictional determination is principally to validate value or size of allowance. Prior to the 1998 regulations, MMS used this precise method, i.e. the cost of comparable service paid by a non-affiliated third party to move through a pipeline in order to approve the size of the transportation allowance.

For subsea production when there is no non-affiliated third party production present in the subsea pipeline, a value can be determined by reference to what other nonrelated parties are paying to move in pipelines in the same field or area. The MMS can use this cost of comparable service provided by non-affiliated parties to validate the allowance for subsea transportation. What is clear is that subsea transportation from the subsea manifold to the surface platform is a valuable transportation service off the lease which adds value to the production. That value for allowance purposes is not zero and should not be limited to a recovery of capital costs. MMS should recognize subsea movement as a transportation deduction from royalty and grant appropriate allowances. In 31 USC §9701, the government itself states that each service or thing of value provided by the government should reflect a charge which is fair, is based on the cost to the government, the value of the service to the recipient and the value of the service itself. Shell asks only that the same factors be applied to determine transportation allowances for royalty purposes.

The MMS has insisted that companies only be allowed to deduct the transportation costs as calculated under a contrived public utility cost of service formulation unique to MMS. The FERC and other regulatory agencies responsible for establishing cost of service rates for regulated entities recognizes the cost of capital of the entity making the investment. The offshore industry, Shell in particular, finances offshore facilities primarily with internally generated funds. As such, a typical equity to debt ratio for an offshore company is closer to 85%/15%. MMS' arbitrary use of a triple BBB bond rate (currently 6% to 7%) as the allowed return on shareholder's at-risk equity would be considered unacceptable by any court. Shareholder equity is subordinate to every other obligation of the company, including to bond holders. So, even if a cost of service type approach were to be allowed, at a minimum it would have to provide for a fair return on the equity portion of the capital structure commensurate with the associated risks and necessary return. MMS itself has used up to 15% as the assumed necessary return for deep water structures.

The allowed return is only one flaw in MMS' determination to change the entire law on oil pipeline rates. Oil pipelines are not public utilities who are guaranteed cost recovery. The model MMS seems intent on forcing on industry is inappropriate for the market structure of the oil pipeline business and counter to recently affirmed congressional intent.

Shell appreciates the opportunity to comment and requests MMS to reconsider classification of subsea production as transportation. Questions should be directed to myself or to M. E. Coney at (504) 728-4643.

Sincerely yours,

Peter Velez

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